China and the Asian contagion

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Abstract:
The Asian financial contagion has so far left China largely unaffected. Nonetheless, Chinese policymakers are genuinely concerned that they may contract the Asian financial contagion and have taken a number of bold steps to bolster their resistance. Unfortunately, China has many of the same structural problems that South Korea, Thailand, and Indonesia had, most notably, bank-dominated financial systems, weak central bank regulation and supervision of commercial banks, excessive lending, and a large buildup of nonperforming loans. It is too soon to say whether China's reforms will succeed.

Full Text:

SO FAR, SO GOOD THE ASIAN financial contagion has so far left China largely, unaffected. Unlike the plummeting currencies elsewhere in the region, the renminbi has appreciated against the U.S. dollar since the onset of the crisis. In real terms the Chinese economy has also fared well. In 1997 the growth of GDP, while slower than the blistering pace of the immediately preceding years, was almost 9 percent in 1997, contrubuting to an unprecedented $40.3 billion trade surplus. Foreign direct investment rose for the seventh consecutive year, reaching $45.3 billion, and China raised an additional $16 billion through debt and equity offerings on international markets. Foreign exchange reserves rose sharply, reaching $139.9 billion by the end of the year, second only to Japan's.

The official outlook for 1998 is also bright. The government is predicting eight percent growth, which would make China far and away the most rapidly expanding economy in the region. It is also forcasting positive growth of importw and expects the renmibi to maintain its value. Achievement of these goals should be warmly welcomed for their contrubutions to Asia's financial and economic recovery.

Nonetheless, Chinese policymakers are genuinely concerned that they may contract the Asian financial contagion and have taken a number of bold steps to bolster their resistance. Unfortunately, China has many of the same structural problems that South Korea, Thiland, and Indonesia had, most notably, bank-dominated financial systems, weak central bank regulation and supervision of commercial banks, excessive lending, and a large buildup of nonperforming loans. It is too soon to say whether China's reforms will succeed.

CHINA'S VULNERABILITIES

EVEN IN a region in which banks dominate financial systems, China stands out. Banks account for nine-tenths of all financial intermediation between savers and investors, exceeding the ratio in almost all other Asian countries. Bank-dominated financial systems, where markets for equity and debt are small, tend to share several closely related problems. First, the lack of well-developed capital markets creates a high potential for systematic underpricing of loans. That, in turn, encourages excessive borrowing by firms with preferred access to credit-state-owned firms in China, the chaebol in Korea, those with government connections in Indonesia and Thailand-while the rest of the economy starves for funds. More generally, capital markets do not provide enough competition for banks, reducing efficiency among financial intermediaries and diminishing rates of return for savers who have little alternative to bank deposits. Finally, whether in China or elsewhere in the region, politicians can more easily influence the pattern of bank lending than determine which borrowers get access to funds raised through capital markets. China's financial and banking system, like others in Asia, suffers from inadequate central bank independence and lax regulation of commercial banks. China's largest banks are not subject to independent audits. Three of China's four largest banks do not even report their consolidated financial results, meaning that losses can be buried in subsidiary firms. Nonperforming loans are classified by more lenient standards than the international norm, impairing the value of the data in measuring bank performance. China's system of setting aside reserves for nonperforming loans is also flawed, since reserve requirements are not linked directly to the quality of each bank's loan portfolio but rather are set at an arbitrarily low percentage.

More alarming, losses due to fraud, corruption, and other lending irregularities in Chinese banks may be similar to those under Indonesia's crony capitalism or the corrupt lending practices South Korean banks used to funnel hundreds of millions of dollars into politicians' pockets. In 1996 the People's Bank of China acknowledged that some banks had lent funds "without recording them in their account books" and that other financial institutions created "false assets" to conceal large losses on their balance sheets. Ominously, the central bank admitted that the number of serious financial crimes was on the rise and that they had been committed in such a manner as to make them more difficult to detect. Since then the situation has worsened. A November 1997 editorial in People's Daily, the Chinese Communist Party newspaper, admitted that "some financial institutions operate in violation of laws and regulations; criminal activities in banking and finance are rampant."

Whether in China or elsewhere in the region, the common elements leading to fraud, corruption, and political influence are inadequate central bank independence and lax regulation of commercial banks. In South Korea, for example, the Bank of Korea was formally subordinate to the Ministry of Finance, which focused on providing a continuous flow of funds to major industrial groups at low cost, precluding the central bank from exercising effective supervision. A key condition of the IMF bailout was legislation making the Korean central bank an independent entity. In China the weakness of the central bank reflects the extreme reluctance of powerful political leaders, especially at the provincial and local level, to relinquish their power to funnel loans to favored industries and firms.

TOO MUCH DEBT

CHINA SHARES an excessive buildup of domestic credit with several countries in Asia. From the beginning of reform in 1978 through the end of 1997, outstanding credit among all financial institutions grew from lgo billion to 7.5 trillion renminbi. As a percentage of GDP, outstanding credit almost doubled, from 53 percent in 1978 to loo percent in 1997. The buildup of credit in China is almost as rapid as that in South Korea and Thailand just before the crisis hit.

The judgment that credit has expanded excessively is based on several criteria. First, an extraordinary deterioration in the balance sheets of state-owned enterprises, which have been the chief recipients of bank credit, has mirrored the buildup of debt. At the outset of reform their balance sheets were quite strong, reflected in a debt-to-equity ratio of about ten percent-about a fourth or fifth of what one would expect among firms in a market economy. Because of a rapid increase in their borrowing, by the end of 1995 the debt-to-equity ratio of all state-owned firms, including commercial establishments and manufacturing companies, exceeded a striking 500 percent. This change implies that many of China's state-owned firms are insolvent-some cannot even cover their operating costs with their income. Because of their highly leveraged position, more and more firms will be unable to service their debts if the economy slows down, further undermining the weak financial position of banks.

A second indicator of too much growth in domestic credit is excess capacity in many industries. Excess capacity is apparent not only in Thailand, Indonesia, and South Korea, but also in China's automobile, beer, home appliance, machine tools, chemical, and chemical fibers industries. According to a 1995 industrial census, capacity utilization was less than 6o percent for more than goo major industrial products.

These countries face a shared challenge not only to reform their financial systems but also to restructure their productive sectors. In South Korea more competition must curb the market power of the chaebol. China's lack of competition is evident not in the dominance of a few firms but in the birth and survival, through access to soft credit, of many small, grossly inefficient local producers. One outstanding example is the automobile industry. In the mid- to late 198os more than 12o vehicle manufacturers were established in China-an astonishingly large number, given the initially tiny market for vehicles and the economies of scale characteristic of the automotive sector. Although production of vehicles of all types tripled from about a half million in 199o to 1.6 million in 1997, the vast majority of the manufacturers produce far too few to take advantage of economies of scale.

Since at least 1994, when it promulgated an automobile industrial policy, the Chinese government has sought to consolidate the industry. But dozens of provincial and local governments have fiercely resisted, each determined to maintain a presence in what the central government has identified as a pillar industry. Some of these localities have nurtured their own producers by imposing restrictions on the sale and licensing of vehicles built elsewhere. A highly restrictive national auto import policy has abetted these efforts. After several cuts, tariff rates on imported sedans are still as high as loo percent, and imports are also subject to quotas and other restrictions. In a more market-oriented economy, with more efficient financial intermediaries and less restrictive trade practices, 120 vehicle producers could never have been established, let alone survived.

A third indicator of excess lending has been the formation of"asset bubbles," particularly in the real estate market. Deng Xiaoping's famous "southern tour" in 1992 stimulated property development on a massive scale throughout China, much of it financed by bank loans. By the mid-lgos, far too much had been built. Beijing, Shanghai, and Shenzhen appear to have the highest concentrations of unleased luxury villas and townhouses and first-class office space, but many smaller cities, ranging from Haikou on Hainan island to Beihai in Guangxi, have a significant problem of overbuilding, as do many county-level towns. In the Pudong Development Area, the financial and manufacturing center that Shanghai created in 1991, total office space in 1997 stood at 13.5 million square feet, an astounding five times the stock at the end of 1994. But about 70 percent of this space is vacant. Shenzhen has enough vacant office space to satisfy the market for three years. The vacancy problem in most large cities is almost certain to worsen since space is expected to increase at a rate several times that at which it has been occupied over the last few years. By 1997 office rental rates had already substantially declined-by about 50 percent in downtown Shanghai, 4o percent in Pudong, and 40 percent or more in Beijing-and were forecast to fall by as much as 70 percent before bottoming out. In retrospect, the repeated boast of Xu Kuangdi, Shanghai's mayor, that one-fifth of the world's construction cranes were at work in his city was more a harbinger of a collapse of real estate prices than an auspicious sign of the city's resurgence.

A fourth vulnerability China shares with the Asian countries in crisis is an enormous buildup of nonperforming loans. In international practice these are loans on which either an interest or principal payment is go or i8o days past due, and they are an important indicator of the health of a banking system. Ultimately the borrowers of nonperforming loans may default, requiring the lender to absorb the loss, drawing on either reserves or its own capital.

According to statements of high offiials, including the governor of the People's Bank of China, Dai Xianglong, the share of nonperforming loans in the portfolios of the four largest state-owned banks has increased steadily in recent years, from zo percent at the end of 1994 to 25 percent by the end of iggy. The ratio of nonperforming loans in China is substantially higher than it was in South Korea or Thailand before the crisis.

SOURCES OF RESISTANCE

DESPITE THESE vulnerabilities, China is unlikely to catch the Asian flu. The Chinese currency is not convertible for capital account transactions. Chinese savers concerned about the viability of the country's financial institutions cannot legally convert their renminbi deposits and purchase foreign currency-denominated financial assets. Moreover, because their ability to convert currency back into dollars is severely limited, foreigners own only small amounts of renminbi-denominated financial assets such as bank deposits or company stock. Indeed, nonresidents are legally barred from purchasing aA" shares-bought and sold for local currency on the Shanghai and Shenzhen stock markets. They must buy foreign currency-denominated and independently priced "B" shares. If foreign sentiment on the value of B shares turns bearish, the value of the Chinese currency would suffer no adverse consequences. Would-be sellers, in effect, cannot get out of the market unless they find a foreign buyer who will pay dollars for their shares.

This situation contrasts sharply with the Southeast Asian picture in the summer and fall of 1997. There, foreign portfolio managers all ran for the exits at the same time, contributing to a sharp decline in local-currency share prices. And when they then sold the baht and other local currencies they had acquired, they exacerbated plummeting exchange rates. Within a matter of weeks the foreign currency values of shares listed on these exchanges had fallen 50 percent or more.

The absence of capital account convertibility also means that speculators, both foreign and Chinese, have no way to act on a suspicion that the renminbi is overvalued and likely to depreciate. Only buyers with a demonstrated need related to trade, tourism, repayment of an approved foreign currency loan, or repatriation of profits derived from a direct investment can purchase foreign exchange. Similarly, access to the futures market for foreign exchange in China is limited to those with a documented trade-related need, precluding speculators from taking short positions in renminbi. Even domestic firms with foreign currency-denominated loans cannot purchase foreign exchange to make payments until their loans come due. That requirement forestalls accelerating demand for foreign exchange among debtors.

China's capital inflows are also predominantly direct investments. Direct investments differ fundamentally from financial investments since they are illiquid and have a long time horizon. Financial investments, such as loans, bank deposits, stocks, and bonds are often short-term and can be reversed quickly if their owners change their minds about the risks of lending to a particular country. Some financial assets can be sold on the market instantly. Lenders can wind down their exposure over somewhat longer periods by refusing to roll over loans when they come due.

In 1997, China received $64 billion in foreign capital, but the largest portion of it, $45.3 billion, was direct investment. Cumulatively, by the end of 1997 foreign direct investment stood at $z25 billion, more than half again as much as the total value of foreign borrowing. In contrast, in the countries in crisis, borrowing exceeds direct investment, sometimes by as much as ten to one.

Unlike Southeast Asia, in the mid-lggos China has also run record trade surpluses. China was $16.7 billion, $12.3 billion, and $40.3 billion in the black in 1995, 1996, and 1997. Thus China was not dependent on continued foreign capital inflows to finance a trade deficit. Finally, at the end of 1997, China's foreign exchange reserves were large enough to finance almost a full year of imports.

INEFFICIENCY IS A DRAG

BUT ALL is not well. China is not immune to the adverse consequences of a rapid buildup of nonperforming loans to state-owned enterprises. Unless reversed, the drain from poor domestic lending decisions will ultimately reduce economic growth, meaning slower job creation and an increased potential for social unrest.

Poor lending decisions are also leading to a huge accumulation of bank liabilities to households, the ultimate source of most of the funds in the banking system. But these liabilities are not matched by real assets. The longer the banks continue to support money-losing state-owned enterprises, the greater the risk that savers will lose confidence in the banking system, triggering a crisis. Even if a crisis can be avoided, the accumulation of nonperforming loans means that the bank recapitalization or financial losses for which depositors are ultimately liable continues to grow. And Chinese banks cannot offer savers consistently positive rates of return, creating a disincentive to save and possibly portending a decline in the savings rate.

China now faces a higher cost of raising money on international capital markets, stemming from a perception that it has some of the same underlying problems evident elsewhere in the region, including a significant understatement of its external debt. In early 1998, Moody's Investors Service downgraded the outlook for nine Chinese banks and the foreign currency debt from "stable" to "negative." Even before the downgrades, the margins on Chinese sovereign debt being traded on the market had widened since their levels before the crisis. As a result, in March China postponed a sovereign bond offering, hoping that the margins would fall by the second half of 1998. Prices of Chinese securities available for purchase by foreigners, including B shares as well as Chineseowned firms listed in Hong Kong, have all fallen sharply. The result is that fewer Chinese companies are being offered on international equity markets, and those that are offered are priced at a much lower multiple of earnings than companies that went on the market before the crisis.

THE CHINESE REFORM PROGRAM

THE CHINESE government recognizes the risks of delaying further fundamental economic reforms. Intense high-level discussion of these dangers began last November when the State Council convened a National Financial Work Conference in Beijing against the backdrop of the financial crisis. Indeed, in an unprecedented move, China contributed Si billion to the IMF-led bailout of Thailand. China is at least temporarily insulated from a currency crisis and is not subject to an IMF-imposed restructuring program. There can be little doubt, however, that Premier Zhu Rongji believes that banks and state-owned enterprises, their principal borrowers, must be reformed.

Jinrong Shibao, China's leading financial newspaper, published jointly by the central bank and several of China's largest financial institutions, commented just after the conference that nonperforming loans are becoming endemic to the system: "A considerable amount of loans extended by banks are disappearing like stones dropped into the sea; principal and interest is difficult to recover; thus the non-performing assets of these banks are increasing."

At the Ninth National People's Congress in the spring, China's leadership confirmed its commitment aggressively to protect China from the Asian financial contagion. Most dramatically, Zhu announced that China would solve the long-standing problems of money-losing state-owned enterprises and weak banks within three years through an accelerated program of privatizations, mergers, closures, and a series of steps that would lead banks to operate on a commercial basis. Among the most important was a reorganization of the local branches of the People's Bank along regional lines to reduce political interference in lending decisions. The initial experiment is under way in southern China where branches in Guangdong, Jiangxi, Guangxi, and Hainan are being consolidated to form a single regional office in Guangdong's provincial capital, Guangzhou. Zhu has been widely quoted as stating "the power of provincial governors and mayors to command local bank presidents is abolished as of i998."

A second major step is a planned injection of 270 billion renminbi into the four largest state-owned banks. This infusion, which will double the capital of the banks, is a prerequisite to the commercialization of the system. Its relatively large size may reflect a belief on the part of the leadership that commercialization is already well advanced.

The central government has also committed substantially more funds to finance write-offs of enterprises' bad debts. This effort began in 1996 with an allocation of 20 billion renminbi to enterprises being restructured. In 1997 3o billion renminbi were earmarked for this purpose. In 1998 the amount was increased to 4o billion, with further increases to follow in 1999 and 2000. Since these funds are generally allocated to assist in the merger of two or more state-owned firms, their use is tied to enterprise restructurings.

The central bank will also allow banks greater flexibility in setting interest rates. The long-standing practice by which the central bank set uniform lending rates for each type of loan precluded banks from pricing loans according to risk. Under the plan, banks will be given increased authority to set lending rates and will be encouraged to take risk into account for individual borrowers. In addition, the presidents of banks with growing nonperforming assets are supposed to be fired. The system of mandatory lending quotas, which has placed a ceiling on total lending and mandated loans to specific projects, is also being phased out. The precise implications of this reform remain to be seen since a system of "guidance quotas for lending" will remain in place.

Since the work conference, the central bank has also tightened supervision and regulation of banks and other financial institutions. It has closed dozens of unauthorized operations, in some cases providing billions of renminbi to prevent depositors from losing their savings. One element of this reform is a new scheme for classifying nonperforming loans, more closely aligned with international standards, which will come into effect by the end of i998. Most important, classification will be based partly on risk rather than exclusively on payment status.

Finally, the State Administration of Foreign Exchange is now required to ensure both that all domestic institutions get advance approval for international commercial loans and that they borrow no more than a certain multiple of foreign exchange-denominated capital and foreign exchange earnings. If followed rigorously, these new regulations would limit the ability of non-financial firms without foreign currency earnings to incur additional foreign exchange risk. They should also curtail borrowing by subsidiaries or affiliates of Chinese firms operating abroad. In some cases, the proceeds from such borrowing have entered China as the foreign contribution to a joint venture and have been reported as foreign direct investments, when they are really foreign currency-denominated loans.

KEEPING OUT OF THE WAY

THE LEADERSHIP has embarked on a daunting transition. A successful reform program would constitute a major breakthrough. It would mean the leadership had found solutions to the problems of moneylosing state-owned enterprises and failing banks that have eluded them for two decades. Domestically, success would improve the allocation of resources, helping to maintain rapid economic growth. Restoring the health of the domestic banking system would reduce the risks of systemic bank failure and help to sustain the high rates of domestic savings that have underlain China's rapid growth in the reform era. Success would make China more likely to maintain its competitive position in Asia by increasing productivity rather than devaluing its currency and possibly setting off another round of currency devaluations. It would help restore China's favorable access to international capital markets and maintain large inflows of foreign direct investment, indirectly helping keep the Hong Kong dollar pegged to the U.S. dollar. All these developments would contribute significantly to recovery in Asia. Finally, successful reform would strike a sharp contrast with Japan, which has not been able to contribute much to solving the Asian financial crisis. Thus China could become as central as Japan to the future of the Asian economy, assuring China's ascendancy not just in the region but in the world.

But the reform program is fraught with risk. China already has an unprecedented unemployment rate, and the political system may not withstand the even higher rates that will accompany the restructuring of state enterprises. Moreover, the transition is beginning under unfavorable external conditions. Drastic currency devaluations have already reduced the growth of Chinese exports and crimped inflows of foreign direct investment. The resulting weakness in the domestic economy will further strain an already fragile domestic banking system.

Another risk is a premature liberalization of domestic financial markets, probably in response to external pressure. While the United States has an interest in assuring that China allow American and other foreign banks to take deposits and offer loans in domestic currency, the insistence of U.S. trade negotiators that China very rapidly open its market for banking services could trigger a domestic crisis. That would start a major recession in China, shutting down Asia's main engine of growth. The United States has a bigger interest in eradicating the Asian financial contagion. That interest will be best served by supporting China's energetic domestic reform program and tempering demands for immediate liberalization of China's banking market.,

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